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POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2015	)	Docket No. ACR2015

REPLY COMMENTS OF THE
AMERICAN CATALOG MAILERS ASSOCIATION

(February 12, 2016)

Pursuant to Commission Order No. 2968 (Dec. 30, 2015), the American Catalog Mailers Association (ACMA) is pleased to submit these comments, which reply to the Initial Comments of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak, VP) in this docket.

The mechanization and automation of letter-mail processing has been a matter of attention for decades. Improvements in the systems have been supported by considerable investment by the Postal Service in everything from processing equipment to containers to transportation arrangements. Visitors to processing facilities in the 1960s and 1970s looked in wonder at large Multi-Position Letter Sorting Machines, known commonly at the time as MPLSMs. Changes since then have involved not only mechanical improvements but also innovations in OCR technology, barcode readers, data collection, and feedback systems. One outcome of all this investment is the high cost coverages now being reported for letters. On the other hand, the processing of flats is not nearly so far along, and low cost coverages for them are being reported.

Valpak's interests are narrow. It wants the Postal Service to give away the return it has realized on its investment in letter-mail processing by lowering the rates for letters (especially saturation letters), and increasing the rates for flats, to the point of driving flats out of the system. Valpak would do this even though, as ACMA explained in its initial comments in this docket, the Commercial flats rates are almost undoubtedly above stand-alone costs.[1] That is, flats mailers, which are constrained by the mailbox rule from achieving delivery privately, are providing a subsidy to the mail system.

As a response to lower rates for letters, Valpak points to "**relative higher elasticity**" for them (VP at 36). According to the demand analysis submitted by the Postal Service on January 20, 2016, it is true that Commercial ECR (a category that includes letters, flats, and parcels, in Carrier Route, High-Density, and Saturation) has an elasticity that is relatively high in absolute value. But we find no information on the record concerning separate elasticities for Commercial ECR letters or flats, or concerning separate elasticities for Saturation, High-Density, or Carrier Route. We note, however, that Commercial ECR includes Carrier Route and that Carrier Route includes a substantial number of catalogs. Catalog mailing models based on reliable

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[1] For further discussion of stand-alone costs, *see* ACMA's Initial Comments in this docket (February 2, 2015).

Whether the Nonprofit rates for flats are above stand-alone costs is open to question. It is far from inconceivable that a private carrier, looking at marginal costs that are not loaded with overhead and other indirect costs would offer lower rates to qualified nonprofit mailers. ACMA supports providing Nonprofit mailers with the lowest rates possible but believes that Commercial and Nonprofit rates and cost coverages should be assessed separately.

information relating to response rates for a range of categories of recipients (which have been made available to the Postal Service, the Commission, and others) show catalogs to have a very high elasticity. Therefore, it is possible that the elasticity of saturation letters is not as high as Valpak believes.

ACMA explained in its initial comments in this docket that the current situation is troublesome in many respects and that this is not a time to pursue rate realignments that would alter in fundamental ways the systems and services of the Postal Service. In the sections that follow, we point to weaknesses in Valpak's initial comments and provide perspective on how the Nonprofit rates should be assessed, a matter that Valpak neglects to mention.

A. A Number of Valpak's Observations Are Misleading.

1. Valpak asserts (at 17) that a decrease in cost coverage of "0.7 percentage points" since FY 2014 indicates a lack of progress in controlling the costs of Standard Flats. Valpak does not note that this decrease was caused by a change in costing method rather than by an increase in Postal Service costs and that on an apples-to-apples comparison, the coverage increased.[2]

2. Valpak makes (at 16) much of the fact that the cost coverage on non-ECR Standard Parcels "has dropped by 12.7 percentage points" from FY 2012 to FY 2015. Valpak does not point out that this decrease was due in significant part, perhaps entirely, to a substantial increase in the proportion of Nonprofit parcels in the category.

[2] When a change in the analysis of accrued costs, and in their attribution to products, is made, it is often called a change in method. The biggest change in FY 2015 was a new analysis of city carrier street costs. The method of regression analysis was used in both the new analysis and the old. For the new, the specific model was changed.

The Postal Service Annual Compliance Report states (at 16) that the cost coverage on this category "improved to 72.8 percent from 70.2 percent in FY 2014." Valpak's table shows a 66.3 percent coverage in FY 2014.

3. Valpak compares the absolute loss reported for Standard Flats in FY 2010 and FY 2015, saying (at 2-3) that the loss went from $582 million to $522 million "**after years of the remedial pricing steps** ordered by the Commission." Valpak does not note that the reduction to $522 million would have been to $471 million without the recent changes in costing method.

4. Valpak argues (at 6) that "another **increase in the unit cost** of Standard Flats (n. From 49.4 cents in FY 2014 to 50.1 cents in FY 2015.)" indicates that there has been "**[n]o [m]eaningful [c]ost [r]ecustion**." Again, Valpak does not note the effect of the change in costing method, which transforms this increase to a decrease.

5. Valpak states (at 6): "The fact that the cost of handling Standard Flats has increased faster than other Standard Mail products is certainly no reason to mitigate price increases for Standard Flats." This is an argument against a straw man. No one has ever suggest that cost increases are a reason for rate decreases. Moreover, it is certainly not true that Standard Flats costs have increased faster than the costs of other Standard Mail products. The USPS-filed CRA reports for FYs 2014 and 2015 (found in each Compliance Report in USPS Library Reference 1) show that the unit cost of Standard Flats increased 1.35 percent, of High-Density & Saturation Letters 13.8 percent, of High-Density & Saturation Flats & Parcels 33.98 percent, and of Every Door Direct Mail Retail 40.21 percent.

6. In an effort to create a version of FY 2015 without the exigent surcharge, to use as a base for thinking about FY 2016 without a surcharge or any other eventualities or rate adjustments, Valpak (at 13) fails to notice that the rate adjustments of May 31, 2015 were in effect for only four months of the year (accounting for 23.4 percent of the volume of the year). Also, it fails to make any adjustment for the increase in volume that should be caused by the surcharge removal.

7. In a section explaining that resource misallocation can result from poor price signals, Valpak (at 35) observes that the volume of Standard Flats increased (+3.8 percent) in FY 2015 and the volume of Carrier Route decreased (–7.7 percent). It does not note that the increase in Standard Flats is due to Postal Service requirements relating to FSS preparation instead of to price signals.

8. Although it refers (at 37) to its leakage-fraction model,[3] which uses elasticities and marginal costs to balance contribution gains and losses, Valpak generally leaves the impression that reducing the losses reported for Standard Flats, via rate adjustments, would translate directly into an increase in the net income of the Postal Service.[4] The truth is, of course, that increasing Standard Flats rates and reducing other Standard rates would improve Postal finances by a small fraction of the reported loss, and that this would occur only if costs and revenues actually do respond according to the model and if there are no repercussions.

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[3] For a discussion of Valpak's model, see Docket No. ACR2012, ACMA Reply Comments (February 15, 2013) at 9.

[4] For example: at 35 n. 24 comparing the net gain from the exigent surcharge with the cumulative Standard Flats loss; at 28 saying "it will be taxpayers that are handed the bill for underwater products"; at 4 referring to the "sum of money it has lost on underwater products"; and at 35 arguing that "deficits by underwater products will erode very quickly" the gains during the pendency of the exigent surcharge.

B. Analyzing the Cost Coverages of Nonprofit and Commercial Categories As A Single Product Artificially Drags Down the Cost Coverage of the Commercial Category.

The Postal Service "agrees with the Commission that having products cover their costs is an appropriate **long-term goal**" (Compliance Report at 17 [footnote omitted, emphasis added], noted by VP at 3). Valpak responds that "[a]lthough it may be considered reasonable under the circumstances for flat-shaped mail to be temporarily relieved from making even a token contribution …, Standard Flats nevertheless should, at a minimum be charged their attributable cost, **without delay**" (VP at 7 [emphasis added]). Then "[t]o provide a perspective" and "to understand" the effect of removing the exigency surcharge, Valpak creates pro forma FY 2015 cost coverages for Standard Flats and Carrier Route with the surcharge removed (VP at 11-13). This is the exercise in which, as noted above, Valpak failed to account for the implementation date of the May 31, 2015 rate adjustments.

As part of this pro forma exercise, because FSS has "shifted some flats-shaped volumes from Carrier Route to Standard Flats" and because "[ACMA] has repeatedly stated that [Standard Flats and Carrier Route] should be viewed together" (at 11-12 [footnotes omitted]), Valpak shows (in its Table I-2) a cost coverage for the Standard Flats and Carrier Route combined. The cost coverage for this combined product is shown to be 96.1 percent, and would be about 97.6 percent if the error regarding implementation of the May 31 increases were corrected. Thus the cost coverage is marginally below 100 percent. But, without offering any rationale for why it is sensible to view Standard Flats as a separate product with a separate cost coverage, Valpak states that it is “proper” to view it as such and shows a lower cost coverage for it (77.0 percent).

ACMA is of the view, more so now than in the past, that there is no logical reason for viewing Standard Flats as a separate product. We explained this further in our initial comments. But ACMA is also of the view that no logical reason exists in law or history for combining the Nonprofit and Commercial categories of Standard Flats and Carrier Route for purposes of assessing rates or determining the adequacy of cost coverages. We explain this further in the next section of these comments. If the Nonprofit categories are excluded from Valpak’s pro forma exercise, the resulting cost coverage is well over 100 percent.

In regard to the non-ECR parcels product in Standard Mail, as introduced above, both Valpak and the Postal Service tangle with this Nonprofit matter. In a section intended to show that “[t]he disparity in cost burden among Standard Mail products is large and growing” (at 15 [initial caps dropped]), Valpak observes (at 16, Table I-3) that the cost coverage of non-ECR parcels decreased by 12.2 percentage points, from 85.5 percent in FY 2012 to 72.8 percent in FY 2015. But Valpak fails to point out that Nonprofit parcels were 5.8 percent of the parcel volume in FY 2012 but are now 26.1 percent. No wonder the cost coverage is down—the Nonprofit parcels have been virtually abandoned.

Regarding the same parcels product, the Postal Service (a) observes the reported cost coverage of 72.8 percent, (b) notes that a large portion of the category’s Commercial parcels were shifted in January 2012 to the competitive products category, and (c) states that it is “committed to improving this product’s cost coverage by proposing above-average price increases in future price adjustments" (Compliance Report at 17).

This should be viewed as a perverse development. Congress made special provision for low rates for Nonprofit parcels. The Postal Service housed them in a product with Commercial parcels, intending that that product have a cost coverage of 100 percent or more. Then the Postal Service moved a substantial portion of the Commercial parcels to the competitive category, presumably to help itself financially, and now explains that it is "committed to … above-average" rate increases for the Nonprofit parcels that remain. Just as for flats, the Commercial and Nonprofit parcels should be evaluated separately.

C. The Way Nonprofit Mail Is Classified Needs to Be Revisited.

Under the Postal Reorganization Act of 1970 and since, special provisions have been made to allow lower rates for mail sent by qualified nonprofit organizations. The way the lower rates have been determined, however, has changed.

In the early years, costs were developed for the Nonprofit categories, and base rates were set at a cost coverage of 100 percent. These were known as "full" rates. Then, for a limited period, actually-paid rates were set below the full rates. These were known as "phased" rates. The Commercial rates were separate and were set independently. Congress appropriated funds to pay the Postal Service the difference between the revenue the Nonprofit mail would have produced had it been charged the Commercial rates and the revenue the Nonprofit mail actually produced. Calculating the appropriation required applying Nonprofit volumes to rate differences, rate cell by rate cell. Handled in this way, providing Nonprofit rates did not place a financial burden on the Postal Service.

The Revenue Forgone Reform Act of 1993 (RFRA) (Public Law 103-213) changed how Nonprofit rates were set and funded. As explained for second-class (now Periodicals) by Postal Service witness Taufique in Docket No. R2000-1, "[RFRA] requires that the markup for the Regular subclass be determined independently based on the factors contained in 39 U.S.C. § 3622(b). The preferred subclasses … [then] receive one-half of the markup determined for [the] Regular subclass[es]."[5] A six-year phase-in of this new arrangement was specified. Congress no longer provided an appropriation. **Since all subclasses in all classes, including the special services, were considered together to meet the breakeven requirement, it was the case that all of the mailers together, not just Standard or Periodicals mailers, funded the lower preferred rates**. There were, however, difficulties with this new law, in that, at least for Periodicals, some of the preferred rates came out above the corresponding Commercial rates. This anomalous and certainly unintended outcome suggested problems in developing separate costs for the preferred categories in the traditional, bottom-up, IOCS way, perhaps due to small samples and errors in identifying the pieces at stages in the mailstream.

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5 Direct Testimony of Altaf Taufique, USPS-T-38 (January 12, 2000) at 2. Joseph Moeller provided similar testimony for third-class (now Standard) in USPS-T-35.

The term "preferred" subclasses referred to subclasses receiving reduced rates. It included nonprofit third-class, nonprofit second-class, classroom second-class, and in-county second class, mainly.

In time for Docket No. R2001-1, RFRA was changed by Public Law 106-384, which amended § 3626(a)(b)(A) to require, for Standard, that the Nonprofit rates be set so that their average per-piece revenue is 60 percent of that of the "most closely corresponding regular-rate subclass."[6] No changes were made in how the reduced Nonprofit rates were to be funded. It was still understood that the markup of the "most closely corresponding regular-rate subclass" was to be set independently, based on the 3622(b) factors.[7] The Postal Service saw that specifically-developed Nonprofit costs were no longer needed, so it stopped developing them.

With the passage in 2006 of the PAEA, Congress left some things unchanged and changed other things. Concerning the Nonprofit rates, the most important thing Congress left unchanged is the 60-percent requirement and the specification that it must be applied to the "most closely corresponding regular-rate subclass of mail." But note that **Congress did not make any changes to suggest that the rates for that "regular-rate subclass" should not be set independently, based on relevant ratesetting guidance consistent with the entirety of title 39 U.S.C. Absent some indication to the contrary, it should be presumed that Congress was happy with the language that existed and with the way it was being applied**.

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6 Even this new arrangement is not without characteristics that some might view as strange. Most particularly, changes in the mix of the Commercial category (i.e., the "most closely corresponding regular-rate subclass") can cause increases in the rates of the Nonprofit categories, and changes in the mix of the Nonprofit categories themselves can have similar effects. To see the strangeness, imagine the Postal Service explaining to a Nonprofit mailer: "The reason your rates increased is that you and your fellow mailers began dropshipping in greater degree. This reduced your average per-piece revenue to less than 60 percent of the corresponding commercial figure, so we had to increase you rates to get your per-piece revenue back up to 60 percent."

7 For a discussion of rate development in Docket No. R2001-1, see the testimonies of USPS witnesses Hope and Moeller, USPS-T-31 and USPS-T-32, respectively.

The changes required by the PAEA involved the price cap and a focus generally on products. The cap is stated to apply at the class level. But it applies only to **changes** in rates, not to **levels** of rates. If the volume weights in the cap calculations are properly applied and the average rate level is not changed, the rates (meaning generally the rate cells and rate elements) within the class could be changed widely (meaning they could be increased and decreased in substantial degree) without violating the cap requirement. Other considerations might suggest moderation, but not the cap itself.

The second change made by the PAEA concerns its focus on **products**. Generally, it replaces the term "subclass" with the term "product." The Postal Service has thusly made product designations (meaning has defined products) on a range of bases, some having little to do with the way the mail is used. Importantly here, the Nonprofit categories and the Commercial categories were made components of the same product. For example, Standard Flats, as designated, is composed of two components, one Commercial and one Nonprofit. This raises questions about how the 60-percent rule should be applied.

Specifically, the term "subclass" was retained in the requirement that Nonprofit rates must be set by reference to the "most closely corresponding [] subclass." This suggests that, as far as the specifics of setting Nonprofit rates are concerned, Commercial and Nonprofit are still to be taken as separate subclasses. The difficulty is clear: If the PAEA's focus on products is taken to mean that subclasses no longer exist, and if the Nonprofit and Commercial categories are components that make up one specific product, how can the rates for Nonprofit be set by reference to the "most closely corresponding [] subclass," or even to the most closely corresponding product, when the obviously-relevant corresponding Commercial category is a component of the same product as the Nonprofit category?

The Postal Service's solution to this conundrum is to take the position that the only logical thing to do is to apply the 60-percent requirement at the level of the class, and it does this across letters, flats, and parcels. The question is: how does this help set the level of the rates for the Nonprofit categories? The answer is: it does not. Does the Postal Service contend, consistent with its interpretation of the best way to carry out the 60-percent requirement, that it could, staying at a given cap level, lower the rates for Nonprofit flats to a level of zero and increase the rates for Nonprofit letters to a level close to the rates for Commercial letters? And if it did this, causing (a) a substantial increase in the volume of Nonprofit flats and (b) the cost coverage of Standard Flats as now defined to sink to a level which in all likelihood would be below 30 percent,[8] would the Postal Service or the Commission take the position that, as a goal, the rates for Commercial Standard Flats should be increased by an order of magnitude to bring the costs coverage of Standard Flats up to an acceptable level? We believe the answer to both questions is "no." Doing either could not be consistent with anything Congress had in mind.

Fortunately, there is a simple way out. Using Standard Flats as an example: The rates for Commercial Standard Flats can be set at a level deemed appropriate.

[8] The reduction on the cost coverage of Standard Flats would be due to the zero rates for the Nonprofit mail and the substantial increase in the volume of Nonprofit. There is no way to estimate the size of such a volume increase. Nonprofit mailers incur mailing costs that go well beyond postage, so free postage would not cause an infinite increase in volume. The size of the increase would also be limited by mailbox clutter.

Then the rates for Nonprofit Standard Flats can be set by applying the 60-percent rule to the rates for Commercial Standard Flats. Although the Postal Service no longer submits rate design workpapers, we believe this is being done now, essentially. If it were not, strange rate behavior would be being observed, and it is not. Then, using the Nonprofit costs that have been submitted in recent years,[9] a separate cost coverage can be calculated for Commercial Standard Flats, and the rates for it can be assessed by reference to, among other things, this coverage. Nothing in this line of reasoning prevents combining Standard Flats and Carrier Route, as Valpak essentially concedes might be sensible and as ACMA has suggested is logical.

In setting and assessing rates in this way, it can be asked who funds the lower rates for the Nonprofit categories. The answer in large part is, as explained above, that they were funded by the overall Postal Service at the time the PAEA was passed and that Congress essentially locked that in by requiring the cap to be applied at the level of the class. To the extent that the relation of the Nonprofit volume levels to the Commercial volume levels changes, the funding borne by the class changes in small degree. But focusing attention on the cost coverage of a product like Standard Flats, or, more appropriately, on a category like Standard Flats and Carrier Route combined, which has both Commercial and Nonprofit components, (a) hides the cost coverage of the Commercial mail, (b) changes away from an independent setting of the Commercial

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[9] The Nonprofit costs are reported in USPS Library Reference 27. They avoid the prospect of the anomalous costing results found in earlier years by working with the costs developed jointly for Nonprofit + Commercial, which provides a larger sample and avoids product identification problems. Then it assumes that Nonprofit pieces cost the same as similar Commercial pieces. Given that the rate cells are finely divided and that the pieces are printed on the same production lines with the same preparation requirements, and might even be comailed, we believe this is a reasonable costing assumption.

rates, and (c) shifts any changes in funding to the associated Commercial category, none of which we see as consistent with the PAEA.

D. Conclusion

The concern Valpak raises is whether questions about the rates for the Standard Flats product as designated rise to a level that "trigger[s] section 101(d)'s failsafe protections" (VP at 8, quoting the Commission). As explained in its initial comments and herein, including the concerns outlined above about how to account for (a) the Nonprofit rates and (b) the interdependence between Standard Flats and Carrier Route, ACMA believes that the questions do not rise to that level and that the rates for Standard Flats are legal. This does not mean that ACMA is happy about the current situation. The Postal Service should possess an efficient flats processing system, and it apparently does not. We do not know whether this is due to underinvestment, poor controls or some other reason. ACMA's larger members have been forced to move a substantial portion of their mail into FSS processing, which appears to cost the Postal Service more instead of less. We are hopeful that improvements are possible and will be made.

Respectfully submitted,

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